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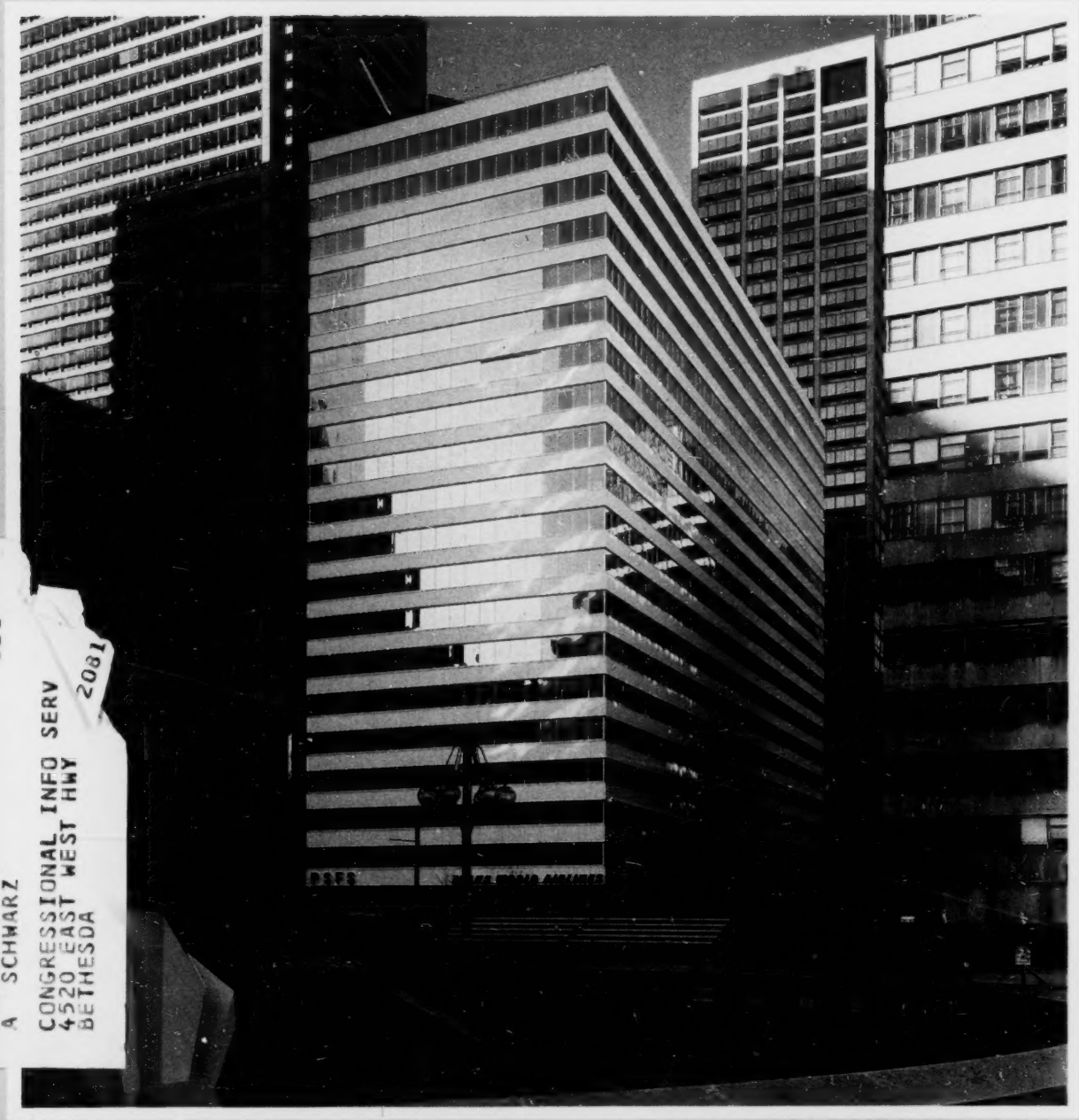
Pension World

The Magazine for Plan Sponsors and Investment Managers/ A Publication of Communication Channels, Inc.



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New Looks Add Value to Older Buildings

Portfolio Insurance: Finding the Right Balance

1986 Real Estate Portfolio Manager Directory

Pension World

September 1986
Volume 22 Number 9

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Cover: **Three Penn Center at 1515 Market Street in Philadelphia was purchased by Richard Ellis, Inc., in 1984. It has been substantially upgraded since its acquisition. Photo by Tom Bernard; courtesy of Richard Ellis. Ronald Derven's profile of the firm begins on page 26.**

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Agricultural investing: The contrarian strategy in real estate

Investing in farmland is not for everyone.

by **JAMES B. McCANDLESS**
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Sometimes it seems the best way to deal with "ironclad" predictions of the crowd is to wait a few years. The crowd is bound to change its mind:

- **1979** "Inflation is here to stay."
- **1985** "Inflation is dead."

- **1974** "Common stocks will never recover."
- **1986** "The Dow-Jones Industrial Average is going to 2000."

- **1979** "Buy farmland."
- **1986** "Don't buy farmland."

Conventional wisdom always sounds like a good idea at the time, but no one ever succeeded by following the crowd. True, some axioms of conventional wisdom do make sense. For instance:

- "You never lose money selling at a profit,"
- "Buy low, sell high," and
- Don't put all your eggs in one basket."

For those who have heeded them, these time-tested bits of advice have yielded solid returns. The real question faced by the serious investor is:

Five Questions to Ask Before Investing in Agricultural Real Estate

Who should invest in agricultural real estate?
Anyone with patient capital, such as a pension plan, foundation, endowment or family trust. A six to eight percent cash-on-cash return, plus the opportunity for appreciation, is a reasonable expectation on investment-quality farm property.

What percentage of a portfolio should be invested in agriculture, and for how long?
For medium to large plans, one to five percent of a portfolio should be considered to diversify wisely in agriculture real estate. A minimum investment of $5 to $7 million and an optimum investment of between $15 to $20 million is generally required to achieve a well-diversified portfolio.

How is income generated?
The investor usually leases the property to a professional farm operator. In many cases, this is the original seller. The buyer and farm operator may then establish a fixed rent or share in operating costs for seed and fertilizer. These arrangements are established by local farm management companies that oversee operation of the property.

Where are the best locations to buy agricultural real estate?
Diversify by both area and crop. Buy only in prime areas of major producing states and avoid marginal land. Select a property that is a typical size for the area. Seek property selling at a 30 to 50 percent discount from 1981 peak prices. The land should be easily accessible and readily leased. Avoid land with buildings. Buildings mean maintenance and can become obsolete quickly.

What crops are best?
The lowest risk and volatility is with row crops of basic commodities. Vineyards, orchards and groves are more risky since trees and vines are subject to disease and storm damage. These types of properties can be more profitable and may be considered by buyers requiring the tax advantages of owning a depreciable agricultural asset.

"Everyone has heard the bad news about the agricultural economy, but few understand the situation that many landowners and landbuyers face . . . While attention is being focused on the problems of the American farmer, agricultural land holds opportunities for ground floor investment."

Table 1 Growth of an Investment Dollar

	Farmland	Common Stocks	Long-term Corporate Bonds
1960	$ 1.00	$1.00	$1.00
1965	1.65	1.87	1.25
1970	2.56	1.87	1.21
1975	6.53	2.23	1.60
1980	13.97	5.30	1.85
1984	13.72	8.06	3.41

Table 2 Increases in Value During Inflationary Period

	Consumer Price Index	% Increase in Average Value Of Farmland
1977	6.8%	19.40%
1978	9.0	12.03
1979	13.3	18.27
1980	12.4	15.45

Table 3 Annualized Risk and Return, 1960-1984

	Volatility	Return
Agricultural Real Estate	7.88%	11.04%
Common Stocks	16.89	8.81
Commercial Real Estate	4.16	8.41
Corporate Bonds	9.63	5.35

Over the period, the average annual inflation rate was 5.24 percent with a volatility of 3.6 percent.

What does it take to identify good investment opportunities? Smart investors know that success depends on timing and relying on experts who understand the forces influencing the market.

Armchair economics

Today the crowd is advising the investor to stay away from agricultural real estate. However, the crowd has not been watching the forces that influence the agricultural real estate market. They look at agriculture from armchairs. As a result, they fail to recognize a sound opportunity.

Of course, everyone has heard the bad news about the agricultural economy, but few understand the situation that many landowners and landbuyers face. In many respects, agricultural investment mirrors commercial investment. Consider the position of the investor who bought an office building in Houston a few years ago. At that time, occupancy and rental rates justified the market price paid. The crowd was cheering. Then the Houston market fell out of bed. Vacancies increased, rents dropped and the oil business slipped into an economic depression. Given today's circumstances, the price the investor paid was too high.

Enter a new buyer. He pencils out a purchase price based on current economics, vacancies and rental rates that will produce a satisfactory return on investment. He makes his offer and buys the building. The crowd would say the new buyer is crazy. Not true. As far as the new buyer is concerned, he is banking on long-term vision and the economic cycle. He is getting in at the ground floor and, if the return is sufficient, then the crowd is crazy!

The knowledgeable investor sees that, while attention is being focused on the problems of the American farmer, agricultural land holds opportunities for ground floor investment. The key is to separate conventional wisdom from the economic forces affecting farmland values. Real estate investors who have taken a professional look at agriculture indicate the following factors as primary forces:

- **Income** — in terms of net income to farmers and rental income to landowners, farmland is an income-producing asset. As income rises and falls, so does the value of the asset that produces it.
- **Expectations of future earnings** — most landowners and farmers will bid up the price of farmland if they believe that future income levels will increase. This is similar to how common stock prices are bid in anticipation of the company's future earnings.
- **Supply and demand** — agricultural real estate is a finite resource. If many buyers are competing for property, they bid up the price of available land. If many sellers are trying to attract a buyer, they will discount the price of their land.

These fundamental forces should reach equilibrium, and this is when the market will bottom out. But this is not an efficient market because not everyone has the same information. Any investor waiting for the crowd to signal that it is okay to buy agricultural real estate will miss sound and profitable opportunities.

What other characteristics of agricultural real estate has the crowd overlooked?

Agricultural real estate is a long-term investment. Even with the de-

clines experienced in the last few years, those who acquired farmland 15 and 20 years ago have an asset today that has yielded a very attractive return and continues to yield a competitive return on its purchase price.

From 1960 to 1984, every dollar invested in farmland would have grown 41 percent more than a dollar invested in common stock and 75 percent more than long-term corporate bonds, according to Ibbotson Associates, an economic and financial consulting firm founded by Roger Ibbotson, professor of finance at Yale School of Management. Table 1 illustrates these findings.

Inflation hedge

Agricultural real estate values are highly correlated with inflation. Ibbotson Associates' 24-year data indicate a correlation of 0.93 for farmland compared to the inflation rate. Since the present rate of inflation is quite low, it's not surprising that farmland values are not increasing. However, in those years of high inflation, farmland yielded attractive "real" returns above the inflation rate, as shown in Table 2.

When farmland prices were falling, the stock market was booming. When farmland prices were booming in the mid-'70s, commercial real estate was in the doldrums. Ibbotson Associates data indicate that farmland is negatively correlated with common stocks and corporate bonds, but it is independently correlated with commercial real estate. Agricultural assets can diversify a portfolio against shifts in the common stock and the bond markets, as well as geographically (by location in the United States) and by individual crop.

Risk is measured by most investors by the volatility of the rate of return on the asset. Most portfolio managers seek investments that dampen instability of the common stock portion of their portfolio. The fluctuation of the total return on farmland is substantially lower than that of common stocks. While low risk is desirable, it is difficult to find assets that also have proven high returns and low risk. Table 3 illustrates that agriculture over the past 24 years was less risky and the returns were over two percent higher than with common stocks.

Aside from investment portfolio decisions, land values will be influenced by a number of domestic and international factors. Since we consume about 70 percent of what we produce and sell the other 30 percent overseas, recovery of the agricultural sector depends heavily on international trade. Any movement of U.S. interest rates and the dollar's exchange value will affect U.S. agriculture competitiveness in world food and fiber markets. Presently, many trends and governmental decisions bode well for American farmers trying to meet foreign competition.

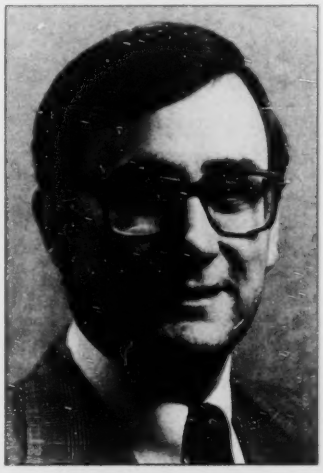
The current adjustment in farmland prices has resulted in a substantial reduction in costs since land is the major cost component of crop production. Lower interest rates have also contributed to cost reductions. Furthermore fuel, oil and gas price reductions have helped to reduce the cost of equipment operations and fertilizer costs.

A weaker dollar is of considerable help in increasing our exports, but it is not the only answer. Lower federal deficits and the lower interest rates that follow will help as well. Stronger growth in the global economy will result in a greater demand for food by Third World nations.

Most observers believe 1986 will not bring much change. Land prices may continue to slip as lower income levels and financial stress hurt farmers. However, most agree that the worst is over, all the bad news is past and the land markets have already responded.

Conclusion

The factors that influence farmland values, income, income expectations and supply and demand have all contributed to opening the window of opportunity for the investor today. Farmland markets have already absorbed the adverse news in the agricultural economy. While no one can predict the day we turn the corner, there are some positive signs on the horizon. Among them are lower interest rates, the relative value of the dollar and global prosperity and economic growth. Agricultural real estate is one of our most basic assets and an investment that the prudent long-term investor should seriously consider. □



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Current Issues In Plan Design

How does an employer handle a COBRA? Very carefully!

Congress has loosed a deadly snake to prey upon employers across the land. COBRA—the Consolidated Omnibus Budget Reconciliation Act—has as its overall objective a reduction in federal spending. This year, Congress included in the Act a number of provisions of special concern to employers, including mandatory provisions for health care continuation coverage.

COBRA requires employers to offer health care benefits to those who would otherwise become ineligible for group coverage: employees who terminate or work reduced hours; surviving, divorced or separated spouses and their dependents; and dependent children who reach the limiting age. Employers may charge "continuees" the "full" cost of the coverage. That sounds easy enough. Employers can fulfill a social need at no company cost.

But beware! COBRA's implications are so broad that, like its slithery namesake, this legislation can surprise even the most expert handler. And those who err may feel its bite.

Employers who fail to comply with COBRA will lose their tax deduction for all group health plan expenses and their highly compensated employees (generally the highest paid 25 percent) will have to include the value of health coverage in their gross income. In addition, plan administrators may be fined up to $100 a day for failure to meet notification requirements. Neither employers' insurance carriers nor their health maintenance organizations (HMOs) are required to provide continuation coverage for employers who fail to provide such coverage. The burden falls on employers and plan administrators.

COBRA requirements are effective for health plan years beginning on or after July 1, 1986, except for plans subject to collective bargaining. For these, the requirements will be effective for plan years beginning after the last plan-related collective bargaining agreement terminates, or January 1, 1987, whichever is later.

Because regulations governing compliance will take time to develop, Congress encouraged employers "to operate in good faith compliance with a reasonable interpretation" of the law. But the law leaves a morass of unresolved issues and employers will have considerable flexibility in their compliance strategy. Furthermore, the law departs from past practice in providing that regulations will *not* be effective retroactively. Later, employers may have to change their strategy to comply with specific regulations, but they should not be at risk for initial compliance strategies based upon a reasonable interpretation of the law.

Yes; no; well, maybe

COBRA's continuation coverage provisions are summarized in Table 1, COBRA Basics. They appear to be relatively simple, but they raise a host of unanswered questions. For example, the legislative history indicates that continuees be permitted to "... modify coverage at the same time and in the same manner as other similarly situated beneficiaries." Does that mean that an employee who has coverage under a high-option medical plan can elect coverage as a continuee under a low-option plan at annual reenrollment? Last May, TPF&C asked employers if they would allow "qualified beneficiaries" to elect a different indemnity plan option. Of 112 respondents who offer multiple options, 30 percent said they would allow qualified beneficiaries to make changes in the same manner as active employees; 54 percent did not yet know what they would do. (Other results are shown in Table 2, Employer Survey Highlights.)

HMO/indemnity plan transfers pose even more difficult questions. If an employee belongs to an HMO and terminates, can he or she purchase continuation coverage under the employer indemnity plan at regular open enrollment? At termination? Of 171 survey respondents who have HMOs, only 29 percent said they would allow HMO members to purchase continuation coverage under an indemnity plan at open enrollment; another nine percent would allow such a change anytime after the "qualifying event." TPF&C also surveyed 14 insurance carriers last May. Only three said they would permit an HMO member to purchase continuation coverage under an employer indemnity plan. (Results are shown in Table 3, Insurance Carrier Survey Highlights.)

Under COBRA, however, continuees retain their right to modify coverage on the same basis as other employees and their dependents. Therefore, regulations may require employers to allow continuees to move from HMOs to indemnity plans (or vice versa) at open enroll-

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Table 1 **COBRA Basics**

Effective date. Plan years beginning after June 30, 1986 except for collective bargaining agreements, which will be subject to COBRA the later of January 1, 1987, or the plan year beginning after the last plan-related collective bargaining agreement terminates.

Qualified beneficiary. An employee or dependent who becomes ineligible for group coverage due to a qualifying event.

Qualifying event. Employment termination or reduction in work hours; employee death, divorce or legal separation; employee entitlement to Medicare benefits; dependent child reaching the limiting age.

Limiting age. The age, usually 19 or 23, at which a dependent child is no longer eligible for group coverage as a dependent child.

Similarly situated beneficiary. Covered employee or dependent who has not experienced a qualifying event.

Notice requirements. Employers have 30 days to notify plan administrators that an employee has died, terminated or is working reduced hours; after receiving notice that a qualifying event has occurred, plan administrators have 14 days to notify qualified beneficiaries of their continuation rights.

Election period. The period during which the qualified beneficiary can make his/her continuation coverage election; starts no later than the date (1) group coverage normally would terminate or (2) the qualified beneficiary receives notice of the right to elect; lasts for at least 60 days.

Maximum coverage period. 18 months for an employee who terminates or works reduced hours (and his or her dependent); 36 months for all others.

Premium. Up to 102 percent of the actual or estimated per capita cost for similarly situated beneficiaries.

Penalties. Lose corporate tax deduction for all group health plan expenses; include value of health plan coverage in income of highly compensated employees; ERISA penalties.

ment. If an HMO does not offer continuation coverage, an employer may have to make coverage available through the indemnity plan when a qualifying event occurs.

And there are other unanswered questions. For example, how will employers who have flexible benefit plans respond to an employee who waives medical coverage under the flex plan, then terminates and wants to elect continuation coverage? What does the law intend? Is it reasonable to deny coverage until regulations are issued? What if a continuee marries or has a child? Is the new dependent eligible for coverage? Maybe—continuees can modify coverage—but the law also says that a qualified beneficiary is an individual who was covered under the plan "the day before the qualifying event."

How much can an employer charge for continuation coverage? Continuees cannot be required to contribute more than 102 percent of the cost of providing coverage for "similarly situated beneficiaries." That seems simple enough, but how is the cost—COBRA calls it the "applicable premium"—to be calculated? The law provides some guidance:

- Under an insured arrangement, the applicable premium is assumed to be the per capita premium the insurance carrier charges.
- A self-insured employer has two options. The employer can estimate the cost of coverage for the same 12-month period for active employees, or use the cost of coverage for the previous year, adjusted by the GNP price deflator. (This method can only be used if there have been no significant changes in the work force or plan design.)
- The applicable premium can be adjusted for coverage (e.g., high vs. low option and single vs. family) and location.

COBRA's cost-of-coverage guidelines appear to be relatively straightforward. But are they really? Can employers age-rate continuation coverage premiums? The answer seems to be yes. Although this approach might be more equitable, it would probably reduce the total amount of contributions because younger qualified beneficiaries, with their lower average costs, would find the plan more attractive than would older beneficiaries with higher average costs.

The law allows employers to adjust continuation coverage premiums for family status. But could an employer who has a contributory indemnity plan for active employees with a three-tier contribution structure (i.e., single employee; employee and spouse; employee, spouse and children) charge a composite continuation coverage premium? In that event, single continuees would be subsidizing those with families. If an employer has high turnover among young, short-service employees and wants them to bear an appropriate share of the expense of continuation coverage, this might be a good strategy because it would make continuation coverage relatively more expensive for the young, short-service group. Of the 198 employers TPF&C surveyed, 21 percent plan to charge a uniform premium, 35 percent will adjust rates and 38 percent do not know how they will calculate premiums.

COBRA also apparently allows employers to charge continuees *less* than 102 percent. Could an employer therefore charge the full amount for former employees who elect continuation coverage but less for other qualified beneficiaries? Might an employer want to provide free coverage to surviving spouses? Would an employer who wants to help older dependent children get advanced degrees require only a modest contribution—say, 25 per-

cent—for dependent children who reach the limiting age? Because COBRA is silent on this issue, employers are bound only by good reason.

Suppose an employer sees a 23-year-old dependent as an adult who should be supporting himself and bristles at offering that "child" continuation coverage. Could such an employer reduce the limiting age to 20? In effect, the before-COBRA coverage would be maintained if the employer paid the continuation coverage premiums until age 23. But is this "good faith compliance?"

Can an employer subsidize certain continuee options? Is it lawful to encourage continuees to join HMOs by subsidizing their membership? For example, continuees might have to pay 102 percent to purchase coverage under the employer indemnity plan but only 50 percent to belong to an HMO. This strategy would give the employer a strong advantage in that the HMO would assume the full financial risk. There appears to be nothing in COBRA that would disallow such an approach. HMOs might be reluctant to accept members on that basis, however.

If favoring HMO membership through greater employer subsidy is defensible, could an employer offer continuees a choice between paying 102 percent for coverage under the standard employer indemnity plan but only half that amount for coverage under a separate, scaled-down, continuees-only plan? Does this strategy violate the requirement that continuees be offered "coverage identical to the coverage provided under the plan to similarly situated beneficiaries?" Continuees can elect to have the same coverage as active employees and their dependents. Does that stay within the cost-of-coverage guidelines? Is it, therefore, reasonable?

Table 2 **Employer Survey Highlights (Based on 198 Respondents)**

Of the employers surveyed by TPF&C on COBRA premium calculations:
- 21 percent will charge all continuees the same rate;
- 35 percent will adjust rates (family status and location are the most common adjustments);
- 38 percent have not decided how they will determine rates.

An overwhelming majority of employers expect to handle COBRA administration. Although only 33 percent of respondents are self-administered:
- 98 percent will send election forms to qualified beneficiaries;
- 69 percent will handle billing (22 percent say continuees will not get bills);
- 93 percent will collect premiums.

Fifty-two percent of respondents have not decided when they will allow qualified beneficiaries to change family status.
- 29 percent will permit changes at the same time as for employees;
- 15 percent will permit changes anytime after a qualifying event.

Sixty percent of companies that offer HMOs do not know if continuation coverage will be available through the HMOs; 32 percent report that their HMOs will offer such coverage. If an HMO member who becomes a qualified beneficiary wants to join the employer indemnity plan:
- Nine percent of employers who offer HMOs will allow such a change anytime after a qualifying event;
- 29 percent will allow such a change at the same time as employees;
- 58 percent are not sure what they will allow.

Fifty percent of self-insured employers plan to continue offering conversion options; 46 percent are undecided.

What we know

In addition to dealing with the issues on which COBRA is silent, employers may find that complying with explicit requirements is a complex task for which they are ill-prepared. Tracking continuee eligibility and communications, billing and premium collection are new tasks for many employers. They will have to develop systems and procedures and assign and train staff.

Although some employers are looking to their insurers/plan administrators to assist with these tasks, some may be unable to get help. Only three of the 14 carriers TPF&C surveyed responded that they would offer billing and premium collection services. At least at first, most employers are planning to handle administration internally. Of the 198 employers who responded to TPF&C's May survey, 97 percent will send election forms to qualified beneficiaries. Even though only one-third of the respondents have self-administered plans, 69 percent will handle billing. (Another 22 percent say continuees will not get bills.) And 92 percent will collect premiums.

Carriers are off the hook—for now. But employers may soon *demand* administrative assistance and carriers will have to respond. Even now, a few carriers are preparing to offer COBRA services. Since none of those surveyed intends to offer any kind of freestanding COBRA product, most employers will have to look to existing insurers/administrators for help.

Administrative structures

Many employers have separate medical, dental, prescription drug and/or vision plans, some of which may have different plan years. The plans may also be administered by different organizations. Obviously, COBRA compliance could be an administrative nightmare for these employers. For example, if an employer's medical plan year begins June 1 and its dental plan year begins October 1, does the employer have to offer just dental continuation coverage until COBRA applies to the medical plan on June 1, 1987? Alternatively, could the sponsor offer no continuation coverage until June 1, 1987? If these same plans are administered by different insurance carriers, how would notification, recordkeeping

and billing be affected? Would the employer have to comply with COBRA for each plan separately? Would one of the administrators provide COBRA administrative services for both plans?

To complicate COBRA compliance even further, suppose an employer has 12 divisions and its benefit plan administration function is decentralized. If one division fails to comply, the entire company will be subject to COBRA sanctions. Ensuring that all units are in compliance might be as difficult as steering a group of tourists through a snake pit.

COBRA's provisions regarding proper notification deadlines are fairly straightforward. There is, however, one glaring omission. In the event of divorce, legal separation or reaching the limiting age, COBRA does not specify how long the qualified beneficiary has to notify the employer/administrator that a qualifying event has occurred. This could result in serious adverse selection. If a dependent, a daughter, say, reached age 23—the limiting age—she could choose not to notify the employer/administrator of her status until she incurs medical expenses. In effect, no premiums would be paid until a claim is incurred. If she were very clever, she could elect to give notice only if her expenses exceeded the total continuation coverage premiums—an actuary's worst adverse selection nightmare.

Employee communication requirements are more vague than those that pertain to notification deadlines. COBRA says, for example, that the summary plan description must include notice of continuation coverage. In addition, a health plan administrator must send written notice to the qualified beneficiary's last known address within 14 days after the administrator has been notified that a qualifying event has occurred. Posting notice regarding the availability of continuation coverage on a bulletin board is insufficient. In June, however, the Department of Labor issued safe-harbor notification language. Employers who use this language will be considered to have properly complied with the notification provision of the law.

Regulations will define communication requirements in more detail. Until they are issued, what guidelines should employers use? Insufficient and inconsistent employee communications have become serious stumbling blocks for employers with respect to retiree medical benefits. The courts' message is, when in doubt, be specific and consistent in both written and verbal communications. Employers would be well-advised to apply this wisdom to COBRA—specifically, to reserve the right to amend and terminate coverage.

What's ahead

As employer health care cost management efforts and the Medicare Prospective Payment System exert financial pressure upon hospitals, paying for care provided to the uninsured has become a difficult problem. Moreover, in this age of the $200 billion federal deficit, Congress is eager to shift responsibility to employers for providing health care benefits to as many people as possible. It is worth noting that with the passage of COBRA, Congress has for the first time enacted broad group benefit plan *coverage* requirements. Historically, mandated coverage has been regulated by state law.

Against this backdrop, employers should expect more legislation in the future. In fact, another bill, the Access to Health Care Act, introduced in Congress last May, would require employers to extend coverage to laid-off workers for up to four months at the same required contribution level as active employees. In addition, the new nondiscrimination rules contained in tax reform legislation will cause employers to provide health care benefits to a larger employee group. Surely, more legislation will follow COBRA. Employers can only hope it will not have as bad a bite. □

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Table 3
Insurance Carrier Survey Highlights
(Based on 14 Respondents)

	Yes	No	Not Sure
Will continuation coverage be funded as other employer coverage?	14	0	0
Will you bill and collect continuation coverage premiums?	3	6	5
Will procedures to certify continued eligibility be different from those used for actives?	0	14	0
Would you be reluctant to allow HMO members to purchase continuation coverage under the employer indemnity plan at open enrollment?	3	5	6
Will your computer systems and software be ready to handle continuation coverage on July 1?	12	1	1
Do you intend to market a separate continuation coverage product?	0	7	7
Will you advise employers to discontinue conversion privileges where not required by law?	0	14	0